

ANALYSIS OF ORIGINAL BILL

Franchise Tax Board

Author: Knight Analyst: Marion Mann DeJong Bill Number: SB 1222

Related Bills: AB 572 (1999/00); Telephone: 845-6979 Introduced Date: 02/26/1999

SB 1478 (1997/98) Attorney: Doug Bramhall Sponsor: _____

SUBJECT: Shift Burden of Proof/Tax Collecting State Agencies

SUMMARY

This bill would add a new provision to the Government Code to shift the burden of proof from taxpayers to the agencies collecting taxes in any court or administrative tax proceeding under certain conditions.

EFFECTIVE DATE

This bill would be operative January 1, 2000, and would apply to legal actions that are filed in connection with tax disputes that arise on or after that date.

LEGISLATIVE HISTORY/BACKGROUND

On July 22, 1998, President Clinton signed H.R. 2676, the Internal Revenue Service Restructuring and Reform Act of 1998 (IRS Reform Act). The IRS Reform Act provides for a massive reorganization of the way the IRS does business and creates a board of directors to help oversee the agency. The IRS Reform Act also provides various taxpayer protections (e.g., burden of proof, innocent spouse and disabled taxpayer relief) and instructs the IRS to promote and improve its electronic filing programs. Finally, the IRS Reform Act eliminates the 18-month holding period for long-term capital gains and contains several technical corrections to the Taxpayer Relief Act of 1997.

SPECIFIC FINDINGS

Under federal law, taxpayers are required to keep certain records and may be requested by the IRS to substantiate items reflected on their federal income tax returns. The IRS may issue a deficiency assessment based on taxpayers' inability to substantiate items reflected on their income tax return or third-party information returns (W-2s, 1099s, etc.). If collection is determined by IRS to be in jeopardy, a jeopardy assessment is issued, whereby the amount of the deficiency is immediately due and payable.

Taxpayers may protest deficiency assessments or jeopardy assessments to the IRS. In the event the IRS denies the protest, under the federal system, the taxpayer may either: (1) file a petition to challenge the deficiency assessment with the Tax Court, or (2) pay the assessment and file a claim for refund with the IRS. Once the claim is denied (or no action is taken by the IRS within six months), the taxpayer may file suit for refund in a U.S. district court or the U.S. Claims Court.

Board Position:

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| _____ S | _____ NA | _____ NP |
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| _____ N | _____ OUA | _____ <u>X</u> PENDING |

Department Director

Date

Gerald Goldberg

4/16/1999

In these legal actions, a rebuttable presumption exists that the IRS's determination of tax liability is correct. In Tax Court proceedings taxpayers have the burden of proving that the deficiency assessment was incorrect. In suits for refund in federal district court or Claims Court, taxpayers have the burden of proving that they are entitled to a refund of overpaid taxes. Taxpayers must establish the merits of these claims by a preponderance of the evidence. These actions are independent judicial proceedings in a trial court based upon information submitted by the parties under rules of evidence applicable in federal courts. Both the taxpayer and the IRS can appeal final adverse determinations to appellate courts, except small claims division determinations which are binding.

The IRS Reform Act shifts the burden of proof to the IRS in any court proceeding for factual issues if the taxpayer introduces credible evidence with respect to factual issues. This change applies to income, estate, gift and generation-skipping transfer taxes. For the burden of proof to shift, the taxpayer must:

- substantiate any item;
- keep records;
- cooperate with the IRS (according to the federal conference report, this includes exhausting the taxpayer's administrative remedies, including any appeal rights provided by the IRS);
- meet the net worth limitations (\$7 million) if not an individual taxpayer.

The burden of proof also shifts to the IRS (1) when the IRS adjusts income through the use of statistical information on unrelated taxpayers and (2) for penalties or when additions to tax are imposed.

Under current state law, all taxpayers may be requested by the FTB to furnish substantiation of the items reflected on their income tax returns and certain taxpayers (i.e., water's-edge taxpayers) may be required to keep certain records. The FTB may issue a proposed deficiency assessment based on: taxpayers' inability to substantiate items reflected on their income tax return, third-party information returns (W-2s, 1099s, etc.), or information FTB receives from IRS. In the rare instance that collection is determined by FTB to be in jeopardy, a jeopardy assessment is issued whereby the amount of the deficiency is immediately due and payable.

If the taxpayer disputes a proposed deficiency assessment or jeopardy assessment, the taxpayer may either (1) protest the proposed deficiency assessment or jeopardy assessment by filing a written "protest" with the FTB, or (2) pay the assessment and file a claim for refund. If the protest of the proposed deficiency assessment or jeopardy assessment is denied, the taxpayer may appeal to the Board of Equalization (BOE). If the appeal is denied by the BOE, the taxpayer must pay the assessment. Under California law, no legal action may be taken in court to challenge a deficiency (other than a deficiency of tax based solely on residence). A taxpayer may bring an action to determine the fact of his or her residence without payment of the tax based solely on residence.

After payment of a disputed tax, a taxpayer may file a claim for refund with the FTB. If the claim is denied or no action is taken on the claim within six months, the taxpayer may appeal to the BOE or initiate legal action for a refund

in superior court. Throughout these processes, the burden to establish that the FTB determination is incorrect is on the taxpayer.

In the event of a final adverse BOE decision on appeal of FTB's denial of the claim for refund, the taxpayer's only recourse is to bring an action for refund against the state in superior court. In litigation, as with administrative appeals, there is a rebuttable presumption that the FTB action was correct. In addition, a taxpayer in a suit for refund is the plaintiff. Consequently, taxpayers (like plaintiffs in other civil actions) have the burden of establishing the merits of their claims by a preponderance of the evidence.

Under current state law, in appeals before the BOE, the FTB has the burden of producing additional information to prove the correctness of an assessment based upon third-party information (e.g., W-2 or 1099) if the taxpayer sets forth a reasonable argument regarding the disputed income, appeals FTB's action and fully cooperates with FTB.

This bill would shift the burden of proof with respect to any factual issue relevant to determining the tax liability of a taxpayer to the agencies collecting taxes in any court or administrative tax proceeding if the taxpayer (1) asserts a reasonable dispute with respect to an issue or issues and (2) fully cooperates with the state agency with respect to those issues. Fully cooperates includes providing, within a reasonable amount of time, access to or inspection of all witnesses, information, and documents within the control of the taxpayer, as reasonably requested by the state agency.

For purposes of **this bill**, state agency includes FTB, BOE, the Employment Development Department (EDD) and any other agency that collects taxes.

This bill would not be construed to supersede or limit the application of any legal requirement to substantiate any item.

Policy Considerations

This bill would raise the following policy considerations.

- This bill does not conform to the federal burden of proof law, but is instead much broader. This bill does not limit the burden of proof shift to smaller taxpayers or court proceedings.

In addition, this bill does not shift the burden of proof to FTB when FTB adjusts income through the use of statistical information on unrelated taxpayers and when penalties are imposed like the federal law.

- Unlike Tax Court or other federal courts, the administrative review of tax cases by the BOE is not governed by formal evidentiary rules. This is designed to provide a "user friendly" forum to taxpayers contesting their assessment. A shift in the burden of proof would necessitate some formalization of the evidentiary elements of these proceedings. Accordingly, while this bill may lead to a "greater balance" between the parties, it may lead to a more formalized hearing process with a greater need for professional representation for taxpayers.

- Generally, in civil cases the burden of proof is on the plaintiff, the party seeking corrective action. The taxpayer is the plaintiff in all California superior court tax refund matters. In addition, for tax cases the taxpayer has control of the records and documents necessary to ascertain the taxpayer's tax liability.

Implementation

This bill would raise the following raise the following implementation considerations. Department staff is available to assist the author with any necessary amendments.

- The bill is internally inconsistent. Subdivision (a) says "notwithstanding any other provision of law," but paragraph (1) of subdivision (c) says, "No provision of the section shall be construed to supersede or limit the application of a legal requirement for substantiation of any item." Subdivision (a) also says that the state agency would have the burden of proof in any "court or administrative tax proceeding," but in paragraph (2) of subdivision (c) says the bill would apply only to "legal actions" filed in connection with tax disputes that arise on or after the operative date of the bill.
- The terms "reasonable dispute," "cooperates fully," "administrative tax proceeding," "tax disputes" and "legal actions" are not defined. Undefined terms can lead to disputes between taxpayers and the department. It is unclear whether a taxpayer that does not maintain records or destroys the records would be fully cooperating. Further, unless administrative tax proceeding is defined, it is unclear if the burden of proof would shift to FTB at all administrative tax proceedings including some internal department administrative proceeding or only at the administrative tax proceedings external to FTB, such as proceedings before the BOE (which is the external administrative proceedings).
- This bill could require FTB to engage in more extensive evidence gathering activities. Additional audit and legal staff may be needed. Shifting the burden of proof to the department may require longer retention of records and increased costs for storage.
- Under current law, FTB is not authorized to require most taxpayers to keep any records (books, papers, writings etc.), statements, returns or other information appropriate to determine the correct amount of tax reported on a tax return. To properly conform to the federal burden of proof provisions, legislation would also be needed to conform to the federal record-keeping requirements.
- It is unclear whether and the extent to which the department would have the burden of proof for factual issues related to federal changes.
- In refund cases or in protest cases where the taxpayer asserts a new issue supporting their position, the department may not have had an opportunity to obtain supporting documents from the taxpayer. It is unclear whether the audit staff would be required to seek additional

supporting data for all cases to protect the state's interest in the event the case is protested or appealed.

- Under certain conditions, this bill would shift the burden of proof to FTB with respect to factual issues relevant to ascertaining the "tax liability" of a taxpayer. It is unclear whether the burden of proof would be shifted to the FTB on factual issues related to penalties and interest. This ambiguity derives from the fact that current law is unclear as to whether penalty and interest are an addition to, and therefore part of, the tax liability of a taxpayer or something separate and apart from the tax.

FISCAL IMPACT

Departmental Costs

The departmental costs associated with this provision are unknown. The costs could increase, however, to the extent that additional supporting evidence would be required on all cases to support the state's position on any potential litigation cases.

Tax Revenue Estimate

Revenue losses in any given year are unknown. It is not possible to determine the number of cases in which the outcome would be changed because of the shift in the burden of proof. It is not clear how the courts would define "cooperating taxpayer."

However, it is understood that this proposal could shift the burden of proof at the time an assessment is protested. Currently, the department has approximately \$1.5 billion of tax assessments in protest status for both PIT and B&CT programs. It is unknown what impacts this change would have on self-compliance reporting and deferred/cancelled assessments in any given year, but potentially could be significant.

The Joint Committee on Taxation in its revenue estimate of H.R. 2676 estimated that shifting the burden of proof would result in a cumulative revenue loss of \$795 million for fiscal years 1998 to 2002. It has been expressed at the federal level that a negative revenue impact from reduced self-assessed reporting may result, which could have an effect on departmental audit programs. Because the language of this bill does not conform to the federal proposed legislation, it is not possible to use the federal revenue impact to measure the impact from this bill.

BOARD POSITION

Pending.

